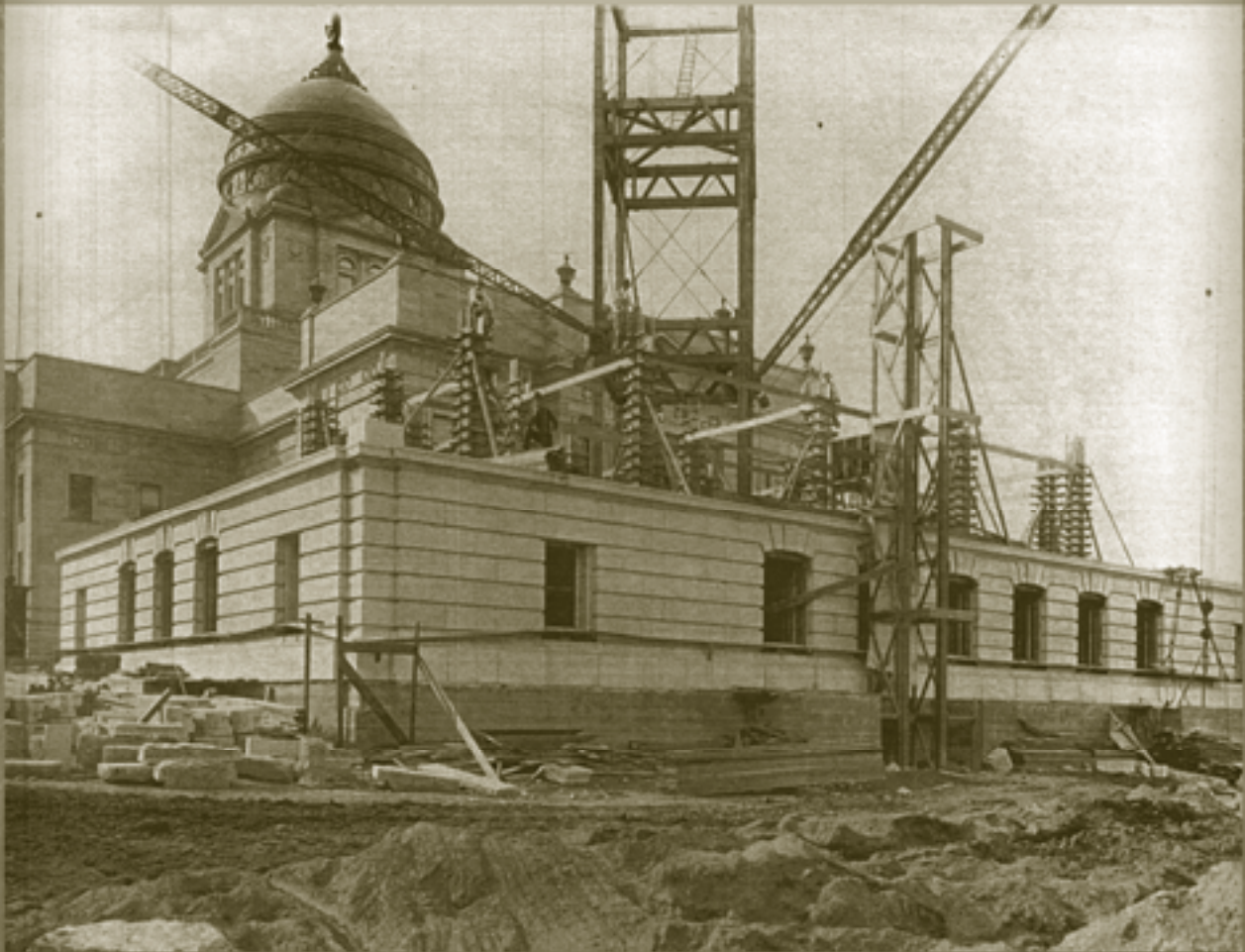


ANNUAL REPORT
2005

MONTANA STATE FUND

BUILDING ON A
HISTORY OF SUCCESS



A Message from the Chairman



On behalf of the Board of Directors, I am pleased to introduce Montana State Fund's annual report for FY 2005. Montana State Fund operates in a very dynamic and competitive environment. Our success in the past and our continued progress in the future are dependent upon our ability to anticipate and respond rapidly to service expectations and industry change.

The growth we are experiencing in premium and policyholders poses both a challenge and an opportunity for our organization. Montana State Fund employees have remained focused on delivering the best product and service possible to policyholders and their injured employees. As you will read in this report, we have undertaken a number of initiatives that will result in higher efficiencies, lower costs and improved delivery of our services.

On a regular basis, the Board of Directors and I have the opportunity to work closely with the employees of Montana State Fund. We admire their dedication and professionalism. The team is focused, dynamic, and innovative. It's a pleasure to be able to work in tandem with these committed individuals as they continue to meet the ever-changing needs of Montana businesses.

We know that maintaining a strong and viable workers' compensation system is crucial to our present and future economic development efforts. We understand the critical role we play in the economic and social well-being of the citizens of our state. It is a responsibility that we gladly accept, and it's what separates us from the other insurance carriers operating in Montana.

We thank you for your continued support.

A handwritten signature in dark ink, appearing to read 'Ed Henrich', with a long, sweeping flourish extending to the right.

Ed Henrich, Chairman



Workplace safety has improved dramatically from the state's early days, and Montana State Fund's commitment to workplace safety continues.

Cranes working in unison speed construction of Fort Peck Dam, one of Montana's largest construction programs in the mid-1930s.



President's Message



Building on Success

After two very financially challenging years, I am pleased to report that Montana State Fund (MSF) achieved a net operating income after a dividend of \$18.8 million in FY05. This performance is a result of our focused efforts that include improvements made in operational efficiencies, skillful case management, and maintaining strong pricing discipline. During this period we saw our net earned premium grow by 26%, exceeding \$189 million. Our investment income rebounded, topping \$29 million. We also increased our loss reserves by \$54 million bringing them to \$464 million. While this is a significant amount of money,

workers' compensation carriers need to maintain adequate case and contingency reserves to ensure that they are able to meet their long-term obligations. Benefits due those who have been injured in a job related accident are defined in law for both indemnity (wage loss) and medical payments. For workers' compensation insurance, premiums are established long before the number, severity, duration, or cost of claims can be known. Case and actuarial reserves are established as claims occur, but the ultimate cost of those claims is not known for many years, sometimes taking as long as 35 to 40 years. Catastrophic and/or unanticipated events may also happen which are not fully covered by annual premiums in any one year. Because the ultimate cost of individual claims is so uncertain, workers' compensation is quite different from all other goods and services where the price is established after most costs of production and delivery are known. For these reasons strong reserves must be established and maintained.

It is also gratifying that we were able to improve our net worth by \$21 million to \$148 million. Often referred to as "surplus" in the insurance industry, funds in excess of reserves are really contingent liability funds available to deal with any future unanticipated liability. By maintaining adequate reserves and a strong net worth based on insurance industry best practices, we are able to continue to operate as a stable, financially strong and long-term viable carrier, committed to the people of Montana.

Looking at FY05 results, we see that accident frequency has remained relatively stable while the severity of injuries reported has continued its upward trend. As the working population ages, the nature and severity of injuries change as well as the time it takes to heal from an accident. Medical inflation has become one of the major issues facing all workers' compensation insurers. Advancements in treatments, new technologies, and increases in physical medicine and pharmaceutical utilization have combined to increase medical costs beyond previously anticipated levels. This will continue to challenge us into the foreseeable future.



Beginning in 1915, Montana became one of the first states to adopt workers' compensation insurance.

Times change. The need for workplace safety never does.

An essential part of our vision as an organization is that we are committed to the health and economic prosperity of Montana. We know that our stakeholders rely on us to be able to maximize our resources to fulfill that vision and our mandate as a competitive state fund. It is a challenge we willingly accept.

No matter how industry and technology progresses over time, there will inevitably be workplace accidents. By maintaining our excellence in safety management to prevent injuries, and by achieving positive outcomes for

injured employees through effective disability management, we deliver the best possible bottom-line results for our customers. In FY05 we implemented a Pharmacy Benefit Manager (PBM) to assist in effective and appropriate prescription medication management. In addition, we initiated our medical and hospital bill review process to ensure appropriate and timely payment for services are made. Importantly, we made substantial progress in development of our new claim management system that will enhance claims examiner productivity and improve claim outcomes.

Legislative Issues

The 2005 legislature accepted the report of the interim committee that studied the role of MSF to determine whether it was in the best interest of the state to sell all or a portion of MSF and create an assigned risk pool. The report recommended that there be no sale of either Montana State Fund or the Old Fund, and that no assigned risk pool should be created. The recommendation also reaffirmed Montana State Fund's role as the guaranteed market for Montana employers, as well as being a competitive marketplace for Montana employers to purchase their worker's compensation insurance under the three-way system.

One of the recommendations the interim committee made was for the legislature to have closer contact with and a better understanding of how the MSF's Board of Directors operates. SB 61 assigned two legislative liaisons to the Montana State Fund board, giving the legislature a better understanding of how the state fund operates as well as how rates are determined. The bill signed into law by the Governor had strong bi-partisan support, and we look forward to a closer working relationship with our legislative leaders.



Many of Montana's traditional workplace environments, such as the framing plant in Rocker, posed significant safety challenges. As Montana's economy continues to evolve, Montana State Fund continues to take a leadership role with workplace safety.

The Judicial Front

At this time, there are a number of court cases in various stages of the judicial process that may result in a significant change to the workers' compensation system in our state. Several pending cases are challenging the constitutionality of certain benefit laws. Should those challenges be successful, insurers will be obligated to pay potentially hundreds of millions of dollars in retroactive benefits for which no premium had been collected. Should this occur, the legislature would need to consider a variety of options required to bring certainty, stability and predictability back into the law.

Credit Where Credit is Due

In closing, I would be remiss if I did not express my appreciation to the Board of Directors. These dedicated businessmen and women come from across Montana and fulfill the responsibility entrusted to them by the legislature to oversee the sound operation of Montana State Fund. I appreciate their willingness to take time away from their own businesses and families to serve our organization. They are to be admired for their dedication to public service on behalf of the citizens of our state.

Laurence Hubbard
President/CEO

Building a Solid Reputation

A broad mix of rugged individualists built Montana's diverse economy. Strong-willed miners, loggers, farmers, ranchers and construction workers toiled in an unforgiving environment to make Montana what it is today. Since 1915, Montana State Fund has been assisting the needs of employers and workers every step of the way. We have built a solid reputation of caring for injured employees, while providing affordable, dependable workers' compensation coverage for our policyholders. Our 284 employees salute the hardworking men and woman of our past and are proud to serve as Montana's insurance carrier of choice and industry leader in service.

Striving to Make Workplace Injuries History

Although safety practices have taken various twists and turns over the years, MSF has strived to provide our customers with the most relevant, up-to-date safety education materials and advice.

The cornerstone of MSF's safety program is our Safety Services Team and Safety Management Consultants. These dedicated professionals enthusiastically nurture and customize the employer safety programs that we offer. This is accomplished through personal visits, quality publications and focused safety trainings.

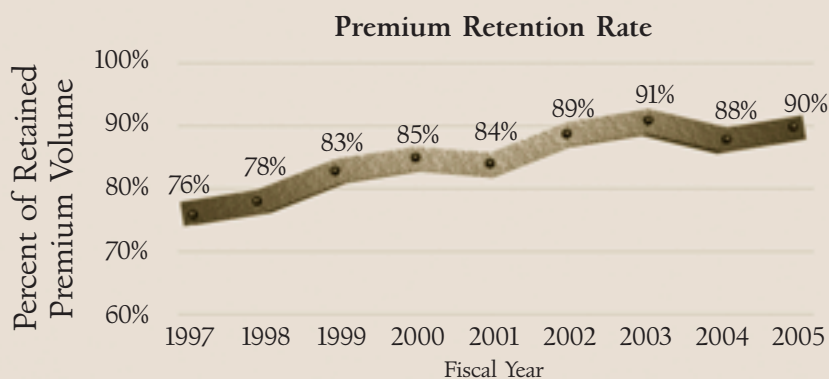
To better serve the needs of employers, we authored a series of "safety culture" brochures. These succinct pocket-size publications were created to make it easier for our customers to improve the safety culture within their businesses.

Continuing in our tradition of quality education, we offered 77 free safety workshops to 970 Montana employers. This is a 20% increase in participation from FY04. These half-day trainings give business owners the skills they need to fine-tune and implement their own safety programs. As part of our ongoing commitment to the health and prosperity of the people of Montana, these workshops are not limited to just our policyholders, but are open to any Montana business owner at no charge.

Policyholders who have superior safety records reaped the benefits by receiving dividend payments. This year over 16,600 policyholders shared in a \$5 million dividend declaration. This was our 7th consecutive dividend payment and rewards those who understand what it means when we say "Safety is no Accident".

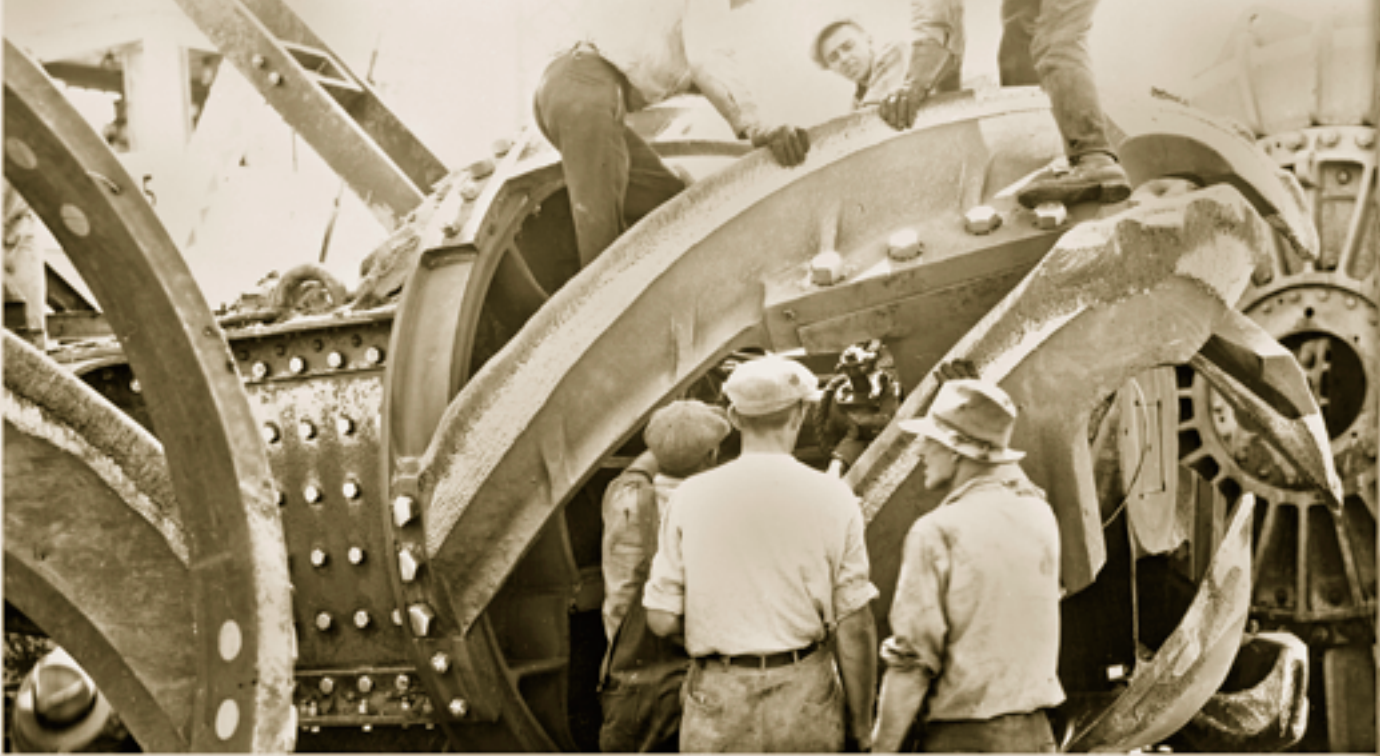
Measuring Up

Unbiased customer feedback is critical in making sure that we are meeting the wants, needs and expectations of our stakeholders. That is why we use the independent consulting firm of Ipsos Reid to conduct our biennial policyholder/injured employee satisfaction surveys.



In the soft market conditions of the late 1990s, MSF's retention of written premium was relatively low by industry standards. However, in the last few years as market conditions have changed and MSF has established itself as the industry leader in service and carrier of choice in Montana, our retention of written premium has dramatically improved. In recent years, we typically retain over 90% of our business from year to year, based on premium dollars.

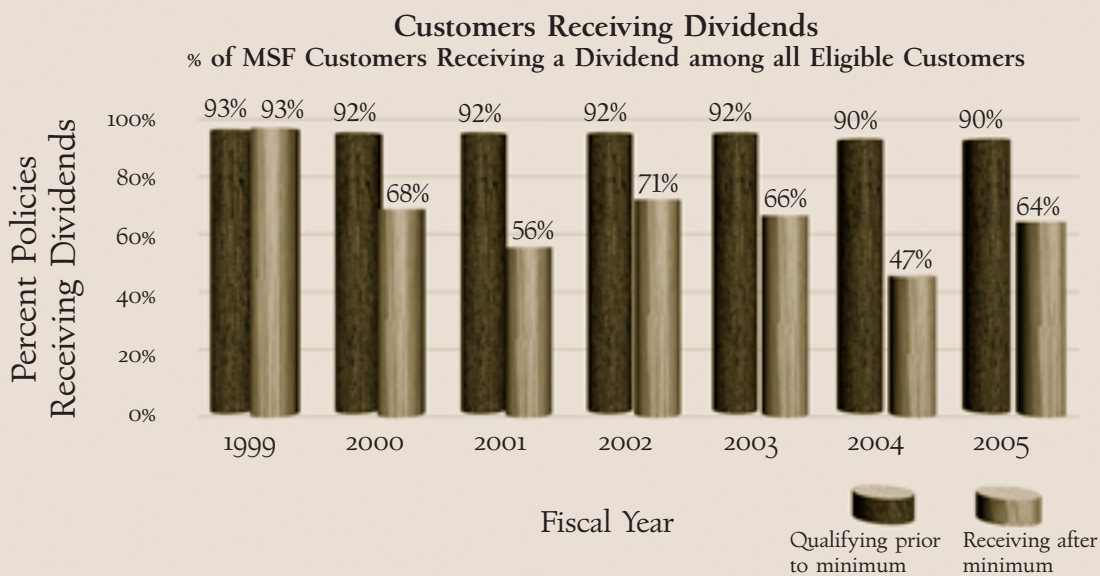
Our most recent survey tells us that we are definitely on the right track. Results found that injured employees overall favorability of MSF improved by a statistically significant 6%. In regards to policyholders, more than nine-in-ten (93%) are satisfied with our staff's courteousness and professionalism, while 88% are satisfied with Montana State Fund staff's knowledge of workers' compensation insurance. We also rank higher than other insurance carriers with whom they have dealt. However, one area policyholders believed needed improvement was our staff's knowledge of the specific challenges they face in their businesses.



Equipment such as this gigantic dredging machine at the Fort Peck Dam site presented significant risks to workers. Montana State Fund's safety management consultants collaborate with employers to improve workplace safety.

Due to this feedback we targeted some key industry sectors among our policyholders and developed programs that addressed their particular needs. Teaming with our trucking industry customers, we developed fleet safety awareness materials they could use to train their employees. We created a training manual entitled "Fleet Safety Management for the Long Haul", and supplemented it with an innovative half-hour safety awareness compact disc ("The Road to Safety") which truckers can listen to in their rigs.

For our farm and ranch customers, we teamed up with the major Montana Agricultural Associations to administer a safety program focused on the special needs of the agriculture workplace. We developed the "Montana Agricultural Safety Manual" which was distributed at agriculture safety workshops held across the state.



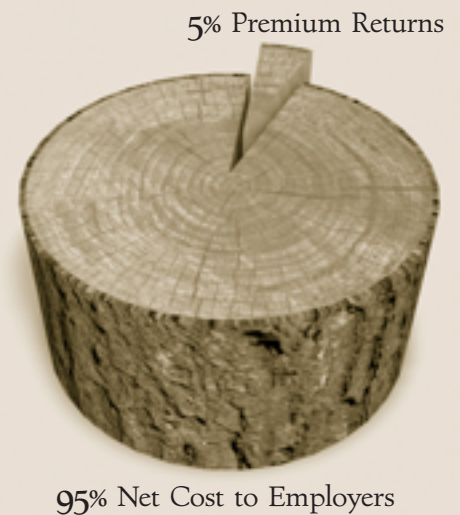
Since 1999 when MSF began issuing dividends, over 90% of eligible policyholders qualify to receive a dividend prior to application of the minimum dividend. Over the past seven years, two-thirds of MSF customers have actually received a dividend each year. Dividends cannot be guaranteed and are contingent upon MSF maintaining a strong financial condition in future years.

Constructing Our Message

Explaining the complexities of workers' compensation insurance has not gotten any easier since our inception 90 years ago. With that in mind, we strive to present our materials with a clear, concise voice.

- Montana's citizen legislators play a significant role in shaping work comp law. However, due to term limits, many of our elected officials are unfamiliar with the history and complexities of the workers' compensation system. To help them gain a better understanding of how all the pieces of the puzzle fit together, we developed a simple, jargon-free brochure that highlighted the history of work comp in our state and important facts that would assist our opinion leaders with the legislative process.
- Over 30,000 policyholders, medical providers, insurance agents, legislators and other interested parties receive our *Perspectives* newsletters. This quarterly publication simplifies relevant work comp issues and offers personal profiles of many of our customers.
- Our independent Montana insurance agent partners are informed about issues of concern to them through our electronic newsletters *Partnership Update* and *Agent Alerts*. The agents provide our customers with the best workers' compensation insurance services around. This partnership, which began in 1997, has grown from 14 pilot agencies to 30 master agencies, employing over 400 agents throughout the state.
- The general public was made more aware of the importance of workplace safety through our "Take the Gamble Out of Workplace Safety" advertising campaign. This multi-media campaign appeared in statewide newspapers, trade publications, association newsletters and on billboards.

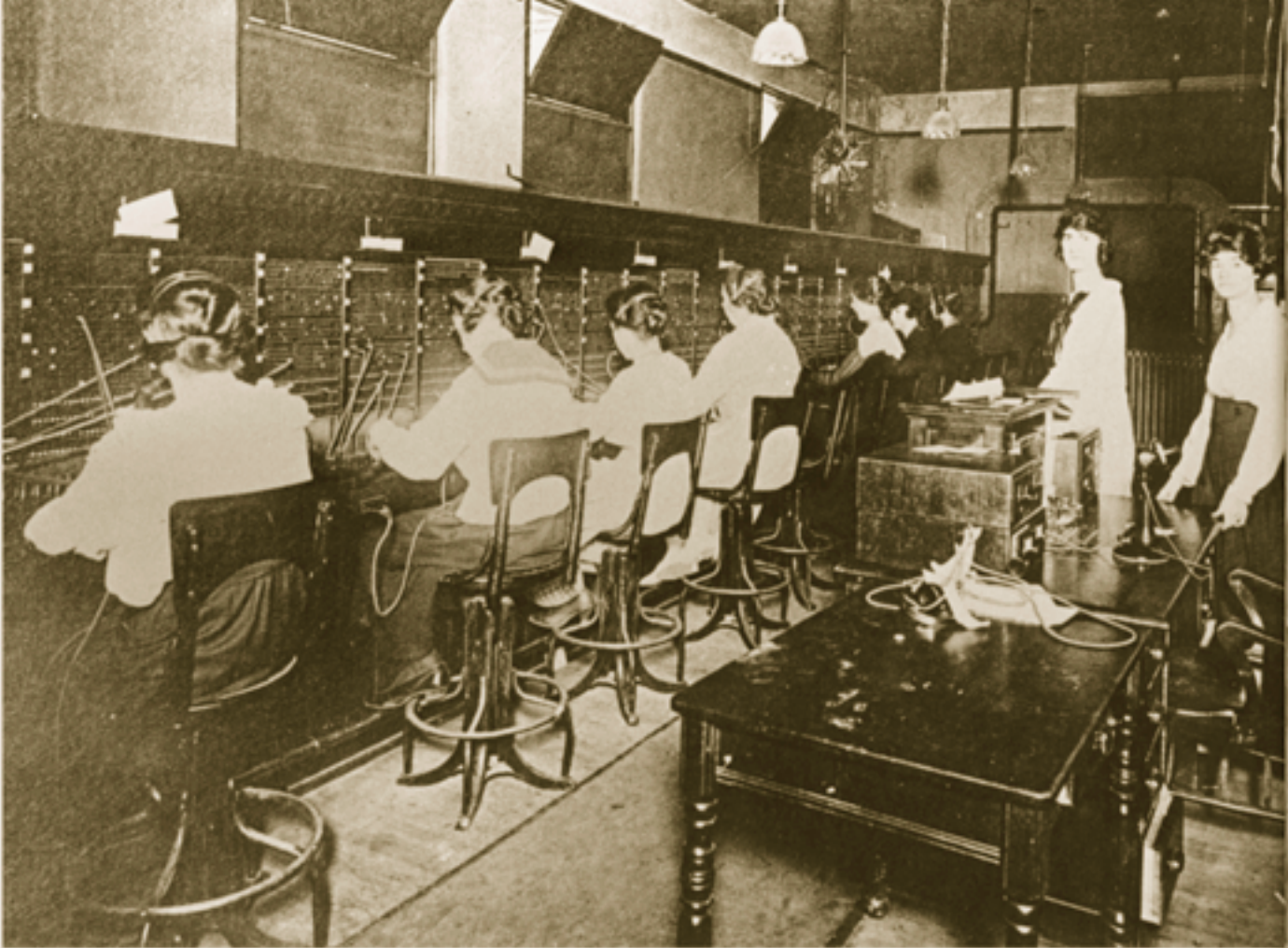
Dividends & Premium Returns Total Up-Front Premium Net of Returns FYs 1999 - 2005



MSF began issuing dividends to its policyholders in 1999. Since that time, 5% of customers' up-front premium costs have been returned in the form of either dividends or loss sensitive plan returns.

A horse-drawn beaverslide stacks hay in the Big Hole valley. Agriculture remains one of the cornerstones of Montana's economy, and changes in technology continue to present new risks for farm and ranch employees.





Long hours at an early telephone switchboard demonstrate that repetitive stress injuries aren't a recent workplace phenomenon. The computer revolution has created new health risks on the job, but it's also provided a wealth of opportunities. Our web-based safety training and interactive payroll and claims reporting have helped Montana State Fund serve our customers faster and better.

Tools of the Trade

The advent of the computer changed the way all of us conduct business. In fact, our survey told us that 90% of our customers have Internet access at their business and utilize it for their ebusiness needs. The creation of our state-of-the-art portal system www.montanastatefund.com is one example of how we have begun to lay the groundwork for providing superior Internet services. Our ever-evolving site is designed to offer policyholders, injured employees, agents and medical providers the power to obtain information whenever they want it.

Speaking of wants, in our most recent survey our customers told us they would like the ability to file their payroll reports online instead of having to fill out and mail their payroll reports to us. That task is now complete.

Another safety tool we added to our site was a convenient Internet-based training system, www.msfsafetytrainer.com. This easy-to-use program allows employees to train right at their desks in far less time and at a lower cost than most traditional teaching methods. Customers can choose from over 195 safety and human resources compliance curriculums. Since inception, a number of Montana employers have taken advantage of the program.

As we move towards the future we envision adding even more specialized Internet programs to our enhanced portal system. With these enhancements comes a responsibility to Montana's employers and workers to remain solid in our commitment to provide quality customer service and competitively priced coverage.

Statutory Statements of Admitted Assets, Liabilities and Equity

as of June 30,

ADMITTED ASSETS

	2005	2004
INVESTMENTS		
Bonds	\$565,851,046	\$499,090,381
Equity Securities	76,737,097	72,138,374
Cash and Short-Term Investments	32,157,356	20,685,046
Other Investments - Collateral Securities on Loan	101,859,456	141,060,425
Total Investments and Cash	<u>776,604,955</u>	<u>732,974,226</u>
OTHER ADMITTED ASSETS		
Premium Receivables	9,655,653	7,818,889
Equipment (net)	786,673	962,632
Interest Receivable	8,206,869	7,520,657
Other Assets	6,569,389	532,037
Total Admitted Assets	<u>\$801,823,539</u>	<u>\$749,808,441</u>

LIABILITIES AND SURPLUS

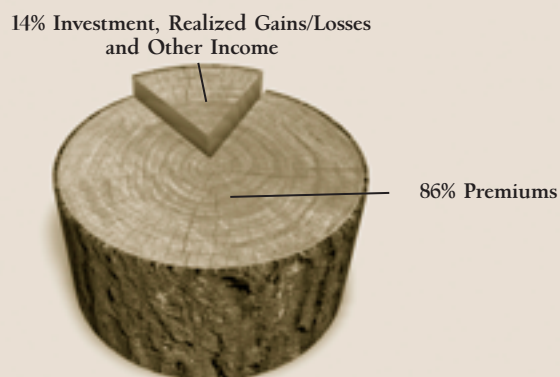
LIABILITIES		
Losses Incurred Reserves	\$464,564,000	\$410,090,000
Loss Adjustment Expense Reserves	46,993,000	42,025,000
Liability for Securities on Loan	101,859,456	141,060,425
Deferred Revenue	4,925,828	5,977,233
Other Liabilities	35,127,384	23,163,627
Total Liabilities	<u>653,469,668</u>	<u>622,316,285</u>

CONTINGENCIES AND SUBSEQUENT EVENTS

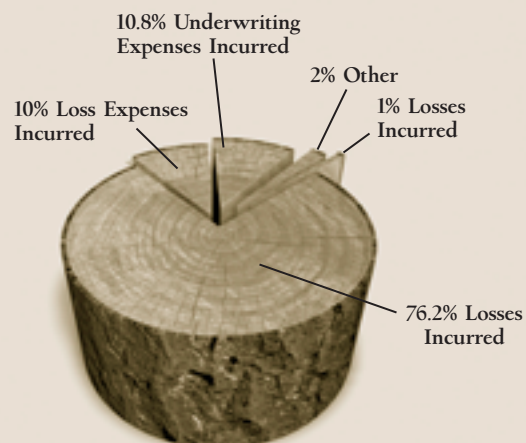
EQUITY

Policyholders' Equity	<u>148,353,871</u>	<u>127,492,156</u>
Total Liabilities and Equity	<u>\$801,823,539</u>	<u>\$749,808,441</u>

The accompanying notes are an integral part of these financial statements.



FY2005 TOTAL REVENUE



FY2005 EXPENSES

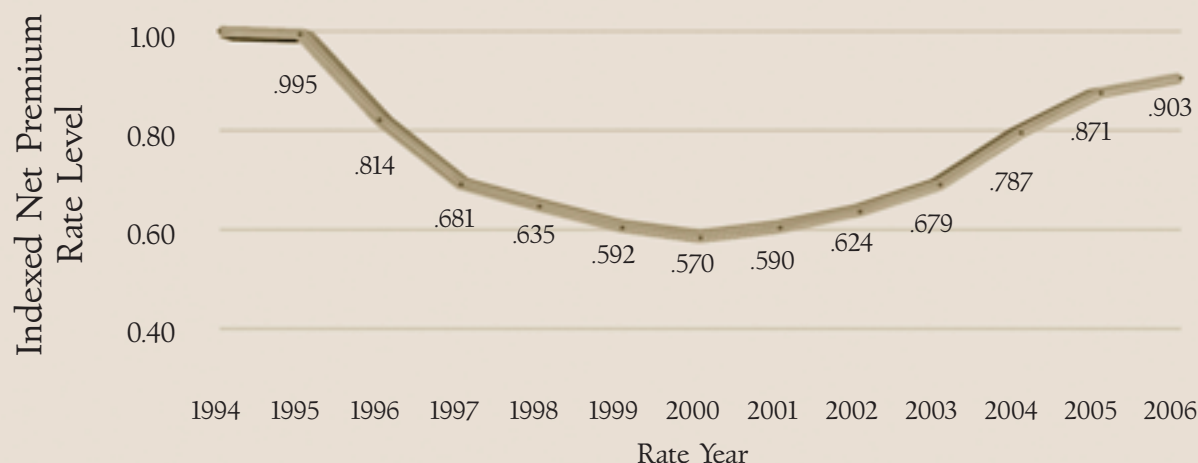
Statutory Statements of Operations and Changes in Equity

for the years ended June 30,

	2005	2004
Net Premium Earned	\$189,378,858	\$139,360,612
Losses Incurred	(152,545,131)	(136,267,288)
Loss Expenses Incurred	(20,185,786)	(14,869,190)
Underwriting Expenses Incurred	(21,638,784)	(20,841,166)
Net Underwriting Loss	<u>\$(4,990,843)</u>	<u>\$(32,617,032)</u>
Net Investment Income Earned	29,125,416	26,562,859
Net Realized Capital Gains (Losses)	1,041,886	1,103,132
Premium Balances Recovered (Charged Off)	(843,697)	(1,200,914)
Other Income	<u>(496,036)</u>	<u>(202,031)</u>
Net Income (Loss) Before Dividends	23,836,726	(6,353,986)
Policyholder Dividends	<u>(5,004,416)</u>	<u>(1,909,856)</u>
Net Income (Loss) After Dividends	18,832,310	(8,263,842)
Prior Year End Equity	127,492,156	121,599,417
Net Unrealized Gains (Losses) on Equity Securities	4,598,723	12,773,545
Change in Nonadmitted Assets	(2,522,786)	1,403,739
Aggregate Write In for Gains (Losses) in Equity	(46,532)	(10,485)
Transfer In (Out), net	<u>-</u>	<u>(10,218)</u>
END OF PERIOD EQUITY	<u><u>\$148,353,871</u></u>	<u><u>\$127,492,156</u></u>

The accompanying notes are an integral part of these financial statements.

MSF Rate Level



MSF rate levels decreased from 1994 to 2000 due to lower medical inflation, declining claim frequency, and statutory benefit changes beginning in 1996. MSF rate levels bottomed out in 2000 and are now rising due to increased medical costs and statutory and judicial benefit expansions. Nevertheless, MSF rates are still 10% below 1994 rates.

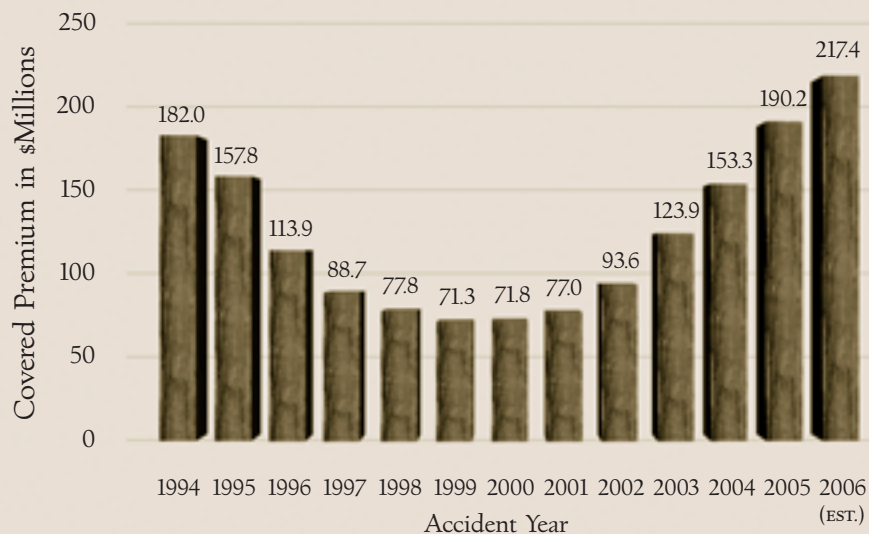
Report of Management

The management of Montana State Fund (MSF) is responsible for the financial statements and all other information presented in this Annual Report. MSF maintains a system of internal control designed to provide reasonable assurance that assets are safeguarded against loss and that transactions are executed and recorded in accordance with management's authorization. This system encompasses the organizational structure, selection and training of personnel, communication and enforcement of policies and procedures, and ongoing internal and external audit programs. Internal controls are continually reviewed and evaluated by management.

The financial statements are presented for our fiscal year ending June 30, 2005 and 2004 and include amounts based on the best estimates and judgments of management. These financial results are presented on a statutory basis, which is consistent with insurance industry financial statement presentation. MSF governs, operates and completes its financial reporting as an insurance company domiciled in the State of Montana, and its financial statements are presented on the basis of accounting practices prescribed or permitted by the Montana Insurance Department.

The statements included in this annual report should not be considered complete audited financial statements. The statements presented are representative of audited financial statements as audited by Galusha, Higgins & Galusha, an independent public accounting firm. Galusha, Higgins & Galusha issued an unqualified opinion on MSF's statutory financial statements. The complete audited financial statements including the accompanying notes are available upon request. The preparation and independent external audit of statutory financial statements is discretionary on the part of MSF, but one that is seen as important. By evaluating the financial results of MSF in comparison to other insurers aids in assessing and maintaining the financial security and stability of MSF as a workers' compensation insurer. In addition, MSF is a component unit of the State of Montana. As required in law the Legislative Audit Division (LAD) of the State of Montana conducts independent audits of financial statements of MSF presented in accordance with generally accepted accounting principles (GAAP) as prescribed by the Governmental Accounting Standards Board (GASB). For the financial periods ending June 30, 2005 and 2004, MSF received an unqualified audit opinion from the LAD. The audited governmental financial statements and the related audit opinion are issued under separate cover. To obtain a copy of the full governmental financial statements, contact the Legislative Audit Division. The presentation of the statutory financial statements in this report differs from the governmental presentation basis (GASB). A financial reconciliation of equity between the audited GASB financial statements and the audited statutory financial statements presented in this report is provided on the following page.

MSF Covered Gross Earned Premium
In \$Millions



MSF premium declined from approximately \$182 million in 1994 to \$71 million in 1999. Since then, gross earned premium has significantly risen as market conditions have changed and rates have increased to cover the increasing cost of claims. MSF will have an estimated \$217 million in premium in 2006. The estimate for 2006 is conservative and subject to change as the year progresses.

When a worker is injured, efficient claims processing and programs help them recover and return to the workforce.



A comparison of GASB to Statutory Accounting Ending Equity for the year ended June 30, 2005 (in 000's):

Governmental Accounting (GASB) Ending Equity	\$ 168,675
Reconciling Items:	
Unrealized Gain on Fixed Income Securities	(20,984)
Net effect of cumulative Unrealized Loss on Equity Securities	8,330
Net effect of cumulative change in Non-Admitted Assets	(7,385)
Other (Deferred Acquisition Costs, etc.)	(282)
Statutory Accounting Ending Equity	\$ 148,354

Quick Facts as of June 30, 2005

Total Earned Premium	\$189,378,858
Number of policies serviced	31,427
Total Number of Claims Processed	14,451
Number of FTEs	284.5
Investment Income	\$30,167,302
Net Income	\$18,832,310
Policyholders Dividend	\$5,004,416
Loss and LAE Reserves	\$511,577,000
Equity	\$148,353,871
Reserves to Equity Ratio (after dividend)	3.45
Premium to Equity Ratio (after dividend)	1.28
Total Fraud Savings Since Inception	\$21,751,347



Current estimates indicate that average claim costs have been on a downward trend over the past several years. We know that general medical costs have been rising and that wage-loss benefits rise by the rate of wage inflation. We believe that the downward trend reflects operational improvements in MSF claims management, getting injured workers back to work more quickly.

Board of Directors



Jane DeBruycker
Dutton



Joe Dwyer
Billings



Ed Henrich
Fairmont



Laurence Hubbard
Ex-Officio, Helena



Ken Johnson
Missoula



Mardi Madsen
Billings



James Swanson
Glendive



Lawrence Zanto
Helena

Executive Team



Standing: Mark Barry, Vice President Corporate Support; Tony Johnson, Vice President Human Resources; Peter Strauss, Vice President Insurance Operations Support; Layne Kertamus, Vice President Insurance Operations; Al Parisian, Chief Information Officer

Seated: Sherrie Handel, Special Assistant to the President; Laurence Hubbard, President; Nancy Butler, General Counsel

Highlights

- MSF awarded a dividend for the 7th consecutive year. Since 1998, \$38 million has been returned to deserving policyholders with superior safety records.
- Our ACE (Assisting Charitable Endeavors) program awarded \$41,077 to 15 worthy projects. ACE makes matching funds available to qualifying Montana non-profit organizations and associations that contribute to both the safety and community well-being in our state.
- Efforts of Special Investigations Unit (Fraud) saved policyholders nearly \$22 million in fraudulent claims since the program's inception in 1993.
- 970 Montana employers attended 77 MSF safety trainings held throughout the state; a 20% increase from 2004.
- Safety Management Consultants visited 1,724 policyholders in the last year.
- Governor Brian Schweitzer appointed Jane DeBruycker of Dutton, Ken Johnson of Missoula, James Swanson of Glendive and Lawrence Zanto of Helena to serve on the MSF Board of Directors. These individuals join Chairman Ed Henrich and Mardi Madsen.
- Our Policyholder Renewal Packet "Renew Your Vows of Safety" received a 2nd place award in the category of Information Kits from the American Association of State Compensation Insurance Funds.
- Chronic Pain Management Associated with Spinal Injuries was the topic for our 4th annual medical education conference. Over 130 medical providers and workers' compensation professionals from across Montana attended the day-long seminar.
- Our Scholarship program assists children and spouses of workers who were fatally injured in a work-related accident. Twelve scholarships were awarded. While nothing can replace the untimely loss of a loved one, we believe that this scholarship program provides an additional benefit for those who are most affected by such a significant loss.
- The Pharmacy Benefit Management program annually saves policyholders \$2 million a year.



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